

FASB Business Combinations Project

September 1999 FASB Exposure Draft, *Business Combinations and Intangible Assets*

FREQUENTLY ASKED QUESTIONS

This document was prepared to respond to questions about the September 1999 FASB Exposure Draft, Business Combinations and Intangible Assets. A copy of the Exposure Draft can be downloaded from the FASB's website at www.fasb.org. This material is presented for discussion purposes only. Official positions of the FASB are determined only after extensive due process and deliberations.

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SUMMARY

On September 7, 1999, the FASB issued an Exposure Draft of a Proposed Statement of Financial Accounting Standards, *Business Combinations and Intangible Assets*. The provisions of that Exposure Draft reflect the following four significant changes to existing accounting practice:

1. Use of the pooling-of-interests method (pooling method) of accounting would be prohibited. The purchase method of accounting would be required for all business combinations.
2. The current 40-year maximum amortization period for goodwill would be reduced to 20 years.
3. Companies would be required to present goodwill amortization on a net-of-tax basis as a separate line item in the income statement to make it more transparent. That goodwill amortization line item would be immediately preceded by a subtotal of income before taxes and goodwill amortization. Companies would be allowed to present, on the face of the income statement, per-share amounts for goodwill amortization and the subtotal immediately preceding it.
4. The current 40-year maximum amortization period for acquired intangible assets (other than goodwill) would be replaced with a presumption that their useful lives are 20 years or less. However, amortization of intangible assets over lives that are longer than 20 years and nonamortization of assets with indefinite lives would be permitted if certain criteria are met.

The Exposure Draft would not change the current requirement to write off the cost of purchased research and development assets at date of acquisition.

Why the Board Decided to Eliminate the Pooling Method

In the Board's view, all business combinations are the acquisition of one company by another, and the purchase method is the appropriate method of accounting for those transactions. The purchase method of accounting for business combinations is consistent with the accounting for all other acquired assets—whether a piece of inventory or a building—all acquired assets are recorded in the financial statements at the exchange price paid. In addition,

- The pooling method provides less information, and less-relevant information, than does the purchase method.
- The pooling method ignores the values exchanged in a business combination while the purchase method reflects them.
- The pooling method does not provide information about how much was invested in the transaction, the type of assets acquired or their fair values, nor can the subsequent performance of an investment be tracked when the pooling method is used.
- Requiring a single method of accounting will make it easier for investors to compare investment alternatives, both domestically and internationally.

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Why the Board Decided That Goodwill Should Be Amortized over 20 Years

Goodwill exists because the value of a company as a whole is greater than the sum of its parts. In the Board's view, goodwill is an asset that comprises various underlying elements integral to the business that cannot be separately identified or easily measured—elements such as the value of the acquired entity's management team or its dominant market position. Goodwill should thus be recognized as an asset, and amortization is appropriate because many of its underlying elements have finite lives. It would not be representationally faithful to depict all elements of goodwill as if they had indefinite lives.

Two important factors that the Board considered in deciding to shorten the maximum amortization period were (1) the rapid pace of technological change that is shortening product life cycles and requiring that companies reinvent themselves more frequently to survive and (2) the evidence provided by companies during field tests indicating that the useful lives of many of the underlying elements of goodwill generally are 20 years or less.

GENERAL

Q1. Why did the Board add a business combinations project to its agenda?

The following were the primary factors considered by the Board in deciding to add a business combinations project to its agenda.

The Board wanted to address perceived flaws and deficiencies in APB Opinion No. 16, Business Combinations. One significant flaw is the fact that two economically similar business combinations can be accounted for using different accounting methods that produce dramatically different financial results. The availability of two methods makes it difficult for financial statement readers to compare the financial statements of companies that use different methods of accounting for business combinations.

Many believe that having two accounting methods affects competition in markets for mergers and acquisitions. Companies that cannot meet all of the conditions for applying the pooling method believe that they face an unlevel playing field in competing for target companies against those that can apply that method. Because companies that can use the pooling method do not have to account for the cost of the investment or its subsequent performance, some believe those companies are willing to pay more for a target than companies that cannot use that method.

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There has been a continuous need to interpret Opinion 16. Despite the fact that Opinion 16 was issued almost 30 years ago, the Emerging Issues Task Force, public accounting firms, and the staffs of both the SEC and the FASB continue to devote significant time to responding to questions about it. Many of those questions are concerned with whether a specific transaction meets the criteria for use of the pooling method.

Because of the rapidly accelerating movement of capital flows globally, there is a need for financial reporting to be comparable internationally. Part of the Board's mission includes promoting international comparability of financial reporting, and accounting for business combinations is one of the most significant areas of difference in accounting standards. In most other parts of the world, the pooling method is either prohibited or used only on an exception basis.

Q2. What issues are addressed in the Exposure Draft?

The Exposure Draft addresses two broad issues: (1) what method should be used to account for business combinations and (2) how goodwill and other intangible assets should be accounted for.

Some current practice issues (such as the accounting for recapitalization transactions) that are not covered by Opinion 16 are also outside the scope of the Exposure Draft. The Board may decide to address those and other issues related to applying the purchase method in a subsequent phase of the business combinations project.

The Exposure Draft also would not apply to combinations between not-for-profit organizations. The Board plans to separately consider the accounting for those transactions, so that it can appropriately consider their unique characteristics (for example, many do not involve the exchange of consideration—at least not in a conventional sense).

Q3. Would the Exposure Draft change the accounting for purchased in-process research and development assets (that is, the current practice of writing off the cost of those assets at date of acquisition)?

No. The Exposure Draft would *not* change the current practice of writing off the cost of purchased in-process research and development (IPR&D) assets at date of acquisition.¹ Following recent research

¹ The accounting for purchased research and development assets acquired in a business combination is addressed by FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*.

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and deliberations on this issue—which included discussions with constituents—the Board concluded that the accounting for purchased IPR&D assets should not be considered separately from the accounting for other research and development costs. The FASB may decide to undertake a separate project at some future date that would reconsider the accounting for research and development in its entirety.

Q4. How will the Board solicit and consider the views of interested parties before a final Statement is issued?

The issuance of the Exposure Draft for public comment is a significant part of the process of obtaining input and views on a proposed Statement. For this Exposure Draft, the FASB is providing a 90-day comment period. Each comment letter received will be read and analyzed to identify issues or alternatives that may not have been considered during the Board's initial deliberations.

The Board also plans to hold four days of public hearings during the first two weeks of February 2000 to directly obtain information and views on the Exposure Draft.

After analyzing input received through comment letters and public hearing testimony, the Board will redeliberate the issues and alternatives raised by commentators in a series of public meetings. Through this process, the Board may decide to modify some of its previous tentative decisions and incorporate suggested changes into the final Statement. The Board will vote on a final Statement only when it is satisfied that all reasonable alternatives have been adequately considered. An affirmative vote from a supermajority of the Board is required for adoption of a final Statement.

Q5. When does the Board expect to issue a final Statement?

To allow adequate time for its extensive due process procedures, the FASB expects that the final Statement will be issued in the fourth quarter of 2000.

Q6. Did the Board seek input from the business community during development of the Exposure Draft?

Yes. The Board requested and received input from a variety of sources throughout the process of developing the Exposure Draft.

A task force was established at the project's inception to assist in (1) identifying the issues to be considered and suggesting alternative solutions, (2) evaluating the costs and benefits of those proposed solutions, and (3) gathering views from associates, clients, and others. Task force members were

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periodically asked for input on specific accounting issues, and they reviewed preliminary drafts of the Exposure Draft. Task force members are broadly representative of the FASB's constituents (including preparers, users, auditors, and academics) and were selected based on the diversity of their views and their knowledge of and experience with business combinations.

During development of the Exposure Draft, the Board twice requested public input on specific project issues.

1. Shortly after the project's inception (June 1997) the Board issued an FASB Special Report, *Issues Associated with the FASB Project on Business Combinations*, describing the proposed approach to the project. That report described the full range of alternative methods of accounting for business combinations that the Board would consider, including the possible elimination of the pooling method. Overall, the written comments received expressed general support for the scope and direction of the project. While a majority of respondents indicated that they favored retaining two methods of accounting for business combinations, many of those respondents indicated they favored further restrictions on the use of the pooling method.
2. The FASB participated in the development of a G4+1² Position Paper, *Recommendations for Achieving Convergence on the Methods of Accounting for Business Combinations*. That Position Paper concluded that only one method of accounting, the purchase method, should be used to account for all business combinations. In late 1998, the Board issued an FASB Invitation to Comment, *Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence*, and received about 150 comment letters in response. The Board carefully considered the views of those respondents before deciding to require the purchase method of accounting for all business combinations.

In addition, the Board received input from the Financial Accounting Standards Advisory Council (FASAC) during quarterly public meetings. FASAC is made up of 30 members who are broadly representative of the FASB's constituents. Valuable input was also obtained from the companies that participated in field tests of one proposed approach to the accounting for goodwill. The Board and its staff also periodically met and discussed various major projects (including the business combinations project) with various industry and professional groups. Views obtained during those discussions were also considered in the process of developing the Exposure Draft.

² The G4+1 is an international group of standard setters consisting of representatives from the accounting standards boards of Australia, Canada, New Zealand, the United Kingdom, and the United States. Representatives of the International Accounting Standards Committee (IASC) also participate as observers.

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METHODS OF ACCOUNTING FOR BUSINESS COMBINATIONS

Q7. Would the Exposure Draft continue to allow business combinations to be accounted for using the pooling method?

No. After carefully considering the issues and input from its constituents, the Board unanimously decided that only one method, the purchase method, should be used to account for all business combinations. The Exposure Draft would specifically prohibit use of the pooling method, even for so called “mergers of equals” (refer to question 15).

Q8. How are the purchase method and the pooling method of accounting for business combinations different?

Under the purchase method of accounting, a business combination is accounted for in the same manner as the acquisition of any other asset—based on the purchase price paid. The excess of the purchase price paid over the fair value of the net assets acquired is recorded as an asset known as “goodwill.” Goodwill is amortized as a charge to earnings over its estimated useful life.

Under the pooling method, a business combination is accounted for by simply adding together the book values of the combining companies as of the date they combine—there is no write-up of net assets to fair value and no goodwill is recorded. Future earnings are not charged with amortization of goodwill or other net asset write-ups. Therefore, post-combination earnings will generally be higher under the pooling method than under the purchase method.

Applying the purchase method and the pooling method produces different financial results, and those differences can be dramatic. The appendix provides a simple example that illustrates the differences between those two methods of accounting.

Q9. How many business combinations are accounted for using the pooling method versus the purchase method?

Various media articles and analyst reports have included different statistics about the number of transactions accounted for by the purchase method and the pooling method. However, those reports support the following general observations.

- In terms of the *number* of business combination transactions, the vast majority (about 95 percent) are accounted for using the purchase method. That proportion has remained fairly constant, even throughout the high level of merger and acquisition activity of the past few years.

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- Recently, there has been an increase in the number of “megamergers” (such as Citibank-Travelers) that have been accounted for using the pooling method. Primarily because of those relatively few, but very large transactions, over half of the total *dollar value* of combinations announced in 1998 were accounted for using the pooling method.
- In certain industries, including banking and high technology, the pooling method appears to be used more frequently than in other industries. Several published articles have reported that over 90 percent of the dollar value of 1998 transactions in the banking industry were accounted for using the pooling method.

Q10. Isn’t the pooling method used to account for all business combinations completed through a stock-for-stock exchange?

No. In order to use the pooling method, a business combination must meet 12 specific criteria outlined in Opinion 16. One of those criteria is that the combination be completed through the exchange of voting common stock. Because of that requirement, *all* transactions accounted for using the pooling method are stock-for-stock exchanges. However, *many* stock-for-stock exchanges are accounted for using the purchase method because they fail to meet one or more of the other criteria for use of the pooling method.

Q11. Why is the financial information provided using the purchase method more useful than that provided using the pooling method?

Under the purchase method, the acquiring company’s financial statements reflect the total purchase price of the investment made and provide feedback about the subsequent performance of that investment. The acquiring company recognizes *all* of the assets acquired (including intangible assets) and the liabilities assumed at their fair value, regardless of whether and at what amount they were recorded on the acquired company’s balance sheet. That is important because in recent years there has been a shift in the asset mix of many industries—a shift away from tangible assets (like property and equipment) toward intangible “knowledge and information” assets. In fact, the most valuable assets acquired in many business combination transactions are intangible assets such as the technological know-how of the acquired company’s workforce, its patents, or its trademarks. Under the purchase method, those valuable intangible assets acquired are recognized by the acquirer and recorded on its balance sheet at their fair value.

The pooling method ignores the values exchanged in a business combination. Under that method, only the assets and liabilities that were recorded on the seller’s books are recognized, and they are recorded at the carrying value in the seller’s balance sheet—that’s like buying land for \$300,000 but recording it at \$30,000 because that is the price the seller paid for it 25 years ago.

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Q12. The G4+1 Position Paper concluded that the purchase method should be used to account for all business combinations. Were the comment letters received supportive of that conclusion?

The respondents were mixed in their support for the conclusions of the Position Paper. About a third of the approximately 150 letters received were from high-technology companies and investment bankers (venture capitalists) that stated that they favored retaining the pooling method primarily for public policy reasons, but did not specifically address the underlying accounting concepts raised in the Invitation to Comment. Of the respondents that provided feedback on the accounting concepts:

- About 30 percent, including a number of major companies, agreed with the conclusion that the purchase method should be the only method used to account for business combinations.
- An additional 20 percent also supported the conclusion that the purchase method should be the only method of accounting for business combinations, but they indicated that they might modify that view depending on the outcome of the Board's deliberations on the accounting for goodwill.
- About 45 percent expressed the view that both the pooling and purchase methods of accounting for business combinations should be retained, but many indicated that they would support limiting use of the pooling method to combinations between entities of similar size, or "mergers of equals."

Q13. What reasons were cited by those respondents to the Invitation to Comment who believe that the pooling method should be retained?

The four reasons most commonly cited for retaining the pooling method are as follows:

1. Mergers (combinations involving the exchange of stock) should be accounted for using the pooling method because they are fundamentally different from acquisitions (combinations effected through cash or debt).
2. "Mergers of equals" or "true mergers" should be accounted for differently from other business combinations, that is, using the pooling method.
3. The pooling method should be retained based on public policy considerations.
4. The growing use of the pooling method stems from shortcomings of the purchase method, primarily the requirement to amortize purchased goodwill.

The Board carefully considered each of those reasons during its deliberations; however, it concluded that use of the pooling method should be prohibited.

Q14. Why did the Board reject the argument that the pooling method should be used for mergers?

Many respondents believe that "mergers" (stock for stock exchanges) are fundamentally different from "acquisitions" (acquiring an entity or net assets with cash or debt) because the shareholders have a

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continuing ownership interest in the combined entity. They believe a different accounting method, the pooling method, is appropriate for merger transactions because they are different from acquisitions.

A business combination occurs when one company acquires the net assets or the equity shares of another company and thereby obtains control over the net assets of that company. The purchase method is the appropriate method of accounting for those types of transactions because it is consistent with the accounting for all other asset acquisitions. The nature of the consideration paid (whether stock, cash, or debt) does not alter the substance of the transaction—the acquisition of assets—and thus should not affect the method of accounting for the transaction.

It is true that ownership interests may be continued in a business combination involving a stock-for-stock exchange; however, they are not the *same* interests. A change in control occurs in those transactions as well—*full control* over one entity is lost, and *partial control* over the combined entity is gained. In the illustration in the appendix, Alpha Co. shareholders have lost full control over Alpha but have acquired control over Beta by virtue of their 66 percent ownership interest in the combined company (Alpha shareholders own 1,000 of the 1,500 shares outstanding after the combination).

Business combinations effected through the exchange of stock also share the attributes of purchase-sale transactions. In purchase-sale transactions, sellers usually profit while purchasers do not. In a business combination, target company shareholders typically receive a premium for their shares and often receive shares that are more widely or deeply traded than those they give up, increasing their liquidity.

Q15. Why isn't the pooling method appropriate for "mergers of equals," that is, combinations that result in shared control over the combined entity?

Business combinations that are "mergers of *true* equals" (combinations characterized by the *equal* sharing of control over the combined entity) occur rarely, if at all. The Board concluded it was not possible to develop criteria that could effectively distinguish those rare true mergers from acquisition transactions. The Board decided that true mergers should also be accounted for using the purchase method because the advantages of having a separate method for those extremely rare transactions are outweighed by the likelihood that the other method would be inappropriately applied to acquisition transactions.

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Furthermore, some members of the Board observed that even if operational criteria could be developed to distinguish true mergers from acquisitions, the fresh-start method rather than the pooling method may be the appropriate method of accounting for those transactions.

Q16. Why did the Board reject the argument that the pooling method should be retained in the interest of public policy?

Some respondents believe the Board should favor public policy over accounting concepts in reaching a decision on whether to retain the pooling method. They argued the pooling method should be retained as is because a decision to eliminate that method may:

- Discourage desirable industry consolidation, which lowers costs to consumers.
- Slow the rapid pace of technological innovation.
- Cause a reduction in the capital available to certain industries.

The FASB's mission is to improve the usefulness of financial information so that investors (and others) can make informed decisions. Accordingly, the FASB believes that accounting standards should be evenhanded and not be slanted for public policy purposes or to favor one set of economic interests over another. Furthermore, if accounting standards were slanted in favor of public policy goals, the accounting rules might need to be changed each time public policy changed.

The objective of the FASB's business combinations project is not to encourage or discourage business combinations but, rather, to improve the accounting for business combinations in a way that will result in more useful information for decision makers. To be useful, financial information must be neutral—that is, it must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior *in any particular* direction. Those who argue that the pooling method of accounting should be retained because its use *encourages* business combinations are not seeking neutral financial information.

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Q17. Some say that the current U.S. accounting standard for business combinations is out of step internationally—don't other countries permit use of the pooling method?

Yes, accounting standards in some other countries permit use of the pooling method, but generally only on an exception basis. Among the G4+1 members, Australia prohibits use of the pooling method and New Zealand has a similar proposal outstanding. The Canadian Accounting Standards Board has also issued an exposure draft of a proposed statement, *Business Combinations*, that would prohibit use of the pooling method in Canada (Canada currently permits use of the pooling method in those transactions in which the acquirer cannot be identified). The accounting standards of both the United Kingdom and the IASC each permit use of the pooling method for certain merger transactions; however, those standards differ not only in how they define a merger, but also in how that guidance is interpreted and applied.

During each of the past several years, the pooling method was used for about 5 percent of the total number of business combinations made by United States companies (about 300 transactions annually). In contrast, companies in all the other G4+1 countries combined completed only a dozen or so mergers that were accounted for using the pooling method, which represents less than 1 percent of all transactions.

Q18. As long as the pooling method is permitted in other jurisdictions, won't U.S. firms be disadvantaged when competing internationally for mergers and acquisitions?

The lack of international comparability in accounting for business combinations was just one of many reasons for adding the business combinations project to the Board's agenda. The decision to eliminate the pooling method was *not* made solely to achieve convergence with other international accounting standards. That decision was made because the pooling method does not provide financial statement readers with useful information and because of the lack of comparability that results from an accounting standard that allows similar transactions to be accounted for differently.

While the current condition-based pooling approach may be perceived as favoring U.S. acquirers when competing in the international mergers and acquisitions market, the Board acknowledges that completely eliminating its use may provide a perceived advantage to international acquirers for whom that method remains an option. Because the Board believes strongly in the principle of neutrality in accounting standards, it is committed to using its best efforts to encourage elimination of even those rare applications of the pooling method that are permitted elsewhere.

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The exposure draft issued by the Canadian Accounting Standards Board would prohibit use of the pooling method. The IASC has established a Steering Committee on accounting for business combinations. As for the United Kingdom, the technical director of the Accounting Standards Board has stated:

If the US bans pooling, the International Accounting Standards Committee (IASC) will come under pressure to ban it and then the UK will have to ask itself whether it wants to be the only country that allows it.³

Q19. Other countries, such as the United Kingdom, permit immediate write-off of goodwill. Won't the proposed requirement to amortize goodwill disadvantage U.S. acquirers when competing internationally for mergers and acquisitions?

The accounting standards of many foreign jurisdictions, including those of the United Kingdom and all other members of the G4+1, require that goodwill be recognized as an asset. The United Kingdom changed its accounting standards in 1998 to discontinue the practice of immediately writing off goodwill to equity. Thus, differences among the accounting standards of the G4+1 members lie in their amortization requirements.

The accounting standards of Australia and New Zealand as well as Canada's exposure draft contain provisions similar to those of the FASB Exposure Draft in that amortization of goodwill over periods exceeding 20 years is prohibited. Under the accounting standards of the United Kingdom and the IASC, goodwill is presumed to have a useful life of 20 years or less; however, amortization over periods greater than 20 years is permitted if certain criteria are met. In addition, the accounting standards in the United Kingdom do allow nonamortization of goodwill if certain criteria are met.

Thus, among the G4+1 members, only the accounting standards of the United Kingdom and of the IASC differ significantly from the FASB Exposure Draft. However, by requiring that U.S. companies present goodwill as a separate income statement line item, readers should be able to more easily understand and compensate for any differences in methods of accounting for goodwill. Further, once accounting standards relating to methods of accounting for business combinations have been substantially converged or harmonized, the G4+1 may undertake similar efforts to achieve convergence on the accounting for goodwill.

³ "Wise Purchase," *The Accountant* (January/February 1999): 13.

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Q20. If the pooling method fails to provide investors with decision-useful information, why hasn't the SEC required disclosure of financial information about business combinations "as if" the purchase method had been applied?

SEC rules and regulations require that financial statements be prepared in accordance with U.S. GAAP. The SEC has historically looked to the private sector for leadership in establishing and improving GAAP and, since 1973, has recognized the FASB as the body to provide that leadership. The SEC's focus is on enforcing compliance with GAAP.

Current GAAP requires that the pooling method be used whenever specific criteria are met, and, therefore, the SEC requires publicly held companies to follow that guidance. Disclosure of financial information "as if" the purchase method of accounting had been applied has not been required in part because of the costs of compliance. Providing those disclosures would require the same effort and cost as would be required to account for the transaction under the purchase method, and, thus, those companies that use the pooling method would be burdened with the costs of applying both the pooling method and the purchase method.

Q21. Did the Board consider the cost-benefit implications of requiring the purchase method for all business combinations? Isn't the purchase method more costly to apply than the pooling method?

Yes, the Board did consider whether the costs of requiring use of the purchase method for all transactions are justified in relation to the expected overall benefits of that proposed change. The Board believes that in the aggregate, any additional costs of applying the purchase method will be more than offset by reductions in the costs associated with use of the pooling method.

The cost of accounting for any particular business combination using the purchase method is usually greater than the cost of applying the pooling method because of the effort required to determine the fair values of assets acquired and liabilities assumed. However, there are other often more substantial costs associated with using the pooling method that would be eliminated if use of that method were prohibited. For example, some companies refrain from certain economically beneficial transactions (such as share repurchase programs or disposals of underperforming segments of acquired companies) because those activities violate the conditions for use of the pooling method. In many transactions, costs are incurred by preparers and their auditors, as well as the SEC in determining which accounting method to apply. Also, having two methods of accounting for business combinations makes it more difficult (and costly) for users

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to analyze and compare financial statements of companies that use different methods of accounting for business combinations.

ACCOUNTING FOR GOODWILL AND INTANGIBLE ASSETS

Q22. Why is the Board reconsidering the current accounting rules for goodwill and purchased intangible assets?

The objective of the business combinations project is to improve the accounting for business combinations so as to provide more useful financial information. Requiring use of a single method of accounting for all business combinations is the most significant step toward that objective. Improving the accounting for purchased intangible assets to better reflect economic reality is the second step toward that objective.

The Board believes that many companies are currently recording short-lived intangible assets as part of goodwill, and, as a result, are amortizing those assets over periods exceeding their useful lives (in some cases, over the maximum 40-year period). The Board also believes that some acquired intangible assets have lives exceeding 40 years (or may have indefinite lives) and that the current requirement to amortize those intangible assets over 40 years does not reflect economic reality. Thus, the Board decided to reconsider the accounting for intangible assets with the goal of providing improved guidance on how to identify and amortize intangible assets. The Exposure Draft includes a list of intangible assets acquired in many business combinations for use in identifying purchased intangible assets. It also eliminates the 40-year maximum amortization period and provides guidance on determining the useful lives of intangible assets acquired.

Q23. What is goodwill?

Goodwill results because the value of an entity as a whole is greater than the sum of its parts. Goodwill represents the amount paid in a business combination for intangible assets that are an integral part of the acquired business but cannot be specifically identified or reliably measured. Examples of those types of intangible assets include the acquired company's superior management team, the technological know-how of its workforce, and its channels of distribution.

Many use the term goodwill to refer to the excess of the purchase price paid over the *book value* of the net assets acquired in a business combination. However, both the current and proposed accounting

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rules measure goodwill as the difference between the purchase price paid and the *fair value* of the net assets acquired. For example, a company that paid \$1,000 for net assets with a fair value of \$800 (and a book value of \$500) would recognize \$200 of goodwill.

Under both the current accounting rules and the Exposure Draft, purchased intangible assets that can be identified and reliably measured, assets such as patents, trademarks, and customer lists, should not be recorded as part of goodwill. Those intangible assets are to be separately recorded and amortized over their useful economic lives.

Q24. How does the accounting for goodwill under the Exposure Draft differ from current practice?

The Exposure Draft would change the accounting for goodwill in two significant ways. First, the Exposure Draft would require amortization of goodwill over the lesser of its useful economic life or 20 years. Currently, the maximum amortization period for goodwill is 40 years. Second, the Exposure Draft would require presentation of goodwill amortization on a net-of-tax basis as a separate line item in the income statement that is immediately preceded by an income subtotal. Disclosure of per-share amounts for goodwill amortization and the income subtotal preceding it on the face of the income statement would be permitted, as the following example illustrates.

Income before taxes and goodwill amortization	\$1,100	
Income tax expense	<u>(440)</u>	
Income before goodwill amortization	\$660	\$0.66 ^a
Goodwill amortization, net of \$40 tax benefit	<u>(60)</u>	<u>\$(0.06)^a</u>
Net income	<u>\$600</u>	<u>\$0.60^a</u>

^aBasic and diluted per share amounts, assuming 1,000 outstanding shares.

Q25. Why did the Board decide to require special income statement presentation of goodwill amortization?

The Board decided that goodwill amortization should be presented as a separate line item in the income statement because goodwill is a unique asset, the useful life of which cannot be determined precisely, and there is a diversity in views about whether or not goodwill should be amortized at all. In addition, some users often weigh goodwill amortization differently from other expenses in their financial analysis, and the proposed presentation would benefit those users.

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Q26. Would amortization of other intangible assets be presented separately in the income statement on the same line item or in the same manner as goodwill amortization?

No. Amortization of other acquired intangible assets may not be presented on the same line item or in the same manner as goodwill amortization. The Board decided that special income statement presentation for amortization of goodwill should be required because of difficulties in determining its useful life. For other identified intangible assets, those uncertainties are not present to the same degree. Thus, those amortization charges should be included in the determination of income before taxes and goodwill amortization. However, the Exposure Draft would require disclosure of the amount of those amortization charges. Some companies may elect to comply with that requirement by presenting amortization of intangible assets other than goodwill in a separate line item (above income before taxes and goodwill amortization.)

Q27. Why did the Board decide to reduce the maximum goodwill amortization period from the current 40 years to 20 years?

The Board based this decision on a number of factors. The Board observed that the rapid pace of technological change was shortening product life cycles and requiring enterprises to reinvent themselves more regularly in order to survive. Nine companies participated in field tests of alternative approaches to accounting for goodwill; they indicated that the useful lives of the elements underlying goodwill were generally less than 20 years. Also, as illustrated in the following chart, many international accounting standards include a presumption that the useful life of goodwill is 20 years or set 20 years as an absolute maximum amortization period.

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	Recognize As An Asset?	Amortization Required?	Maximum Life (Years)
United States (proposed)	Yes	Yes	20
United Kingdom	Yes	Yes (generally)	None (20 presumed)
Canada (proposed)	Yes	Yes	20
Australia	Yes	Yes	20
New Zealand	Yes	Yes	20
IASC	Yes	Yes	None (20 presumed)

Q28. Some argue that the value of goodwill does not diminish over time. Why did the Board decide that goodwill must be amortized?

Goodwill is different from any other asset. While it is measured as a residual, goodwill is made up of a variety of different underlying elements that cannot be separated from the business as a whole. Those underlying elements, such as the strength of an acquired company's current management team and the value of its distribution channels, are difficult to separately identify and value. Some of those elements have finite lives (such as the strength of the current management team), while others may have indefinite lives.

The Board was unable to develop an operational approach that would separately identify and measure the elements of goodwill with indefinite lives. Thus, because at least some of the underlying elements of goodwill have finite lives, the Board decided that all goodwill should be amortized. It would not be representationally faithful to depict all elements of goodwill as if they had an indefinite useful life. Another factor considered by the Board was the fact that it was unable to identify effective methods of reviewing goodwill for impairment.

Q29. Many believe goodwill should be written off immediately at date of acquisition. Did the Board consider that approach?

Yes. The immediate write-off of goodwill was one accounting alternative considered, but the Board could not justify its use.

Some argue that goodwill should be written off immediately at date of acquisition because of uncertainties associated with measuring its subsequent value. In the view of the Board and many of its

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constituents, if goodwill is an asset at the date of acquisition, virtually no event other than a catastrophe could result in it becoming worthless instantaneously. Also, if the uncertainties surrounding goodwill were so great as to warrant its immediate write-off, those same uncertainties should have been present during the acquisition and would have been considered in establishing the purchase price.

Q30. How would the Exposure Draft change the accounting for purchased intangible assets other than goodwill?

APB Opinion No. 17, *Intangible Assets*, currently limits the amortization period for intangible assets to a maximum of 40 years. The Exposure Draft would eliminate that 40-year maximum and replace it with a presumption that the useful life of an intangible asset is 20 years or less. However, intangible assets with useful lives longer than 20 years would be amortized over those longer lives if certain other criteria are met.

The Board also believes that some intangible assets have useful economic lives that are indefinite and therefore amortization of those assets is inappropriate. The Exposure Draft would permit nonamortization of intangible assets with indefinite lives if they meet certain criteria. Those intangible assets would be reviewed for impairment annually.

The Exposure Draft also would require disclosure of information about each significant class of intangible assets acquired, such as their fair value at date of acquisition, the method of determining that fair value, and their weighted average useful life. Annual financial statements would include disclosure of the gross carrying amount, accumulated amortization and amortization expense for each class of intangible asset, as well as the amount and description of any intangible asset not being amortized.

Q31. Would the Exposure Draft require or permit disclosure of “cash earnings”?

Some users are increasingly focusing on measures often referred to as “cash earnings,” such as EBITDA (earnings before interest, taxes, depreciation, and amortization), that exclude certain noncash charges like goodwill amortization. The Board decided that consideration of other measures of reporting financial performance was beyond the scope of the business combinations project. However, the requirement to present goodwill amortization net-of-taxes as a separate line item in the income statement is intended to provide users with information about the cash flow effects of those charges.

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EFFECTIVE DATE OF THE PROPOSED STATEMENT

Q32. Would the pooling method be eliminated effective January 1, 2001, as many media reports have indicated?

Not necessarily. Under the effective date and transition provisions of the Exposure Draft, use of the purchase method of accounting would be required for all business combinations *initiated after* the date the final Statement is issued. (A transaction is initiated on the date the major terms of the plan, including the ratio of shares exchanged, are publicly announced.) Currently, the FASB estimates that the final Statement will be issued late in the fourth quarter of 2000, leading many to the conclusion that the pooling method would be eliminated as of January 1, 2001. Depending on when the final Statement is actually issued, however, the date after which the pooling method would be prohibited may be earlier or later than January 1, 2001.

Q33. Would the Exposure Draft have any impact on business combinations that were accounted for using the pooling method under Opinion 16?

No. Under the proposed transition provisions, business combinations initiated on or before the date the final Statement is issued would be grandfathered under Opinion 16. Retroactive application of the purchase method to past transactions accounted for using the pooling method would not be required or permitted.

Q34. How would the Board's decision impact combinations between entities under common control that are currently accounted for in a manner similar to a pooling of interests?

The Board decided to retain the present practice of accounting for transactions between companies under common control (such as transfers of net assets from a parent to a subsidiary and the combination of two wholly owned subsidiaries into a single subsidiary) in a manner similar to the pooling method, that is, using carryover basis.

Q35. When the final Statement is issued, will companies be required to reduce the amortization period of any existing goodwill to 20 years?

No. The provisions of the Exposure Draft that would limit the goodwill amortization period to 20 years apply only to goodwill acquired in business combinations initiated *after* the date the final Statement is issued. With one exception, the Exposure Draft would have no effect on the amortization period of goodwill arising out of past transactions.

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That one exception relates to goodwill acquired before October 31, 1970.⁴ The Exposure Draft would require that the unamortized balance of that goodwill be written off to net income as an effect of a change in accounting principle in the first interim or annual period ending after the final Statement is issued.

Q36. When the final Statement is issued, will companies be allowed to present amortization of existing goodwill on a net-of-tax basis as a separate line item in the income statement?

Yes, in fact, companies will be required to present amortization of existing goodwill on a net-of-tax basis as a separate line item in the income statement. Companies issuing comparative financial statements would be required to restate prior-period income statements to conform to those display requirements.

Q37. Would companies be allowed to retroactively apply the nonamortization provisions of the Exposure Draft to intangible assets acquired in past business combinations?

No. Companies would be required to continue to amortize all intangible assets acquired in past business combination transactions, even if those intangible assets meet the nonamortization criteria in the Exposure Draft.

⁴ Goodwill acquired before October 31, 1970 is accounted for in accordance with ARB No. 43, Chapter 5, "Intangible Assets," the business combination accounting standard that preceded Opinions 16 and 17.

Comparison of Purchase Method and Pooling-of-Interests Method
(Alpha Company acquires Beta Company as of January 1, 2XX1, in a
one-for-one stock swap of 500 shares with a market value of \$7/share, or \$3,500)

	Before the Business Combination		Beta Co. @ Fair Value (3)	Alpha and Beta Combined	
	Alpha Co. (1)	Beta Co. (2)		Purchase ^A Method	Pooling ^B Method
Balance Sheets as of January 1, 2XX1:					
Assets recorded before combination	\$5,000	\$2,500	\$3,300	\$8,300	\$7,500
Patents			1,000	1,000	
Goodwill			600	600	
<i>Total assets</i>	<i>\$5,000</i>	<i>\$2,500</i>	<i>\$4,900</i>	<i>\$9,900</i>	<i>\$7,500</i>
Liabilities recorded before combination	\$2,800	\$1,400	\$1,400	\$4,200	\$4,200
Stockholders' equity	2,200	1,100	3,500	5,700	3,300
<i>Total liabilities & stockholders' equity</i>	<i>\$5,000</i>	<i>\$2,500</i>	<i>\$4,900</i>	<i>\$9,900</i>	<i>\$7,500</i>
Income Statement for 2XX1:					
Net income of Alpha and Beta	\$2,400	\$1,200		\$3,600	\$3,600
Less: Purchase method adjustments					
Additional depreciation expense				(40) ^C	
Patent amortization expense				(100) ^D	
Goodwill amortization expense				(30) ^E	
Add: Cost savings from combination				300 ^F	300 ^F
<i>Net income</i>	<i>\$2,400</i>	<i>\$1,200</i>		<i>\$3,730</i>	<i>\$3,900</i>
Number of shares outstanding	1,000	500		1,500	1,500
<i>Earnings per share</i>	<i>\$2.40</i>	<i>\$2.40</i>		<i>\$2.49</i>	<i>\$2.60</i>

^A Alpha records the net assets of Beta and the purchase price paid (at fair value). The combined balance sheet is thus the sum of columns (1) and (3).

^B Alpha records the net assets of Beta that it acquires at the amounts recorded by Beta. The combined balance sheet is thus the sum of columns (1) and (2).

^C The asset write-up of \$800 relates to equipment that is being depreciated over its average useful economic life of 20 years (\$40 annual depreciation expense).

^D Patents valued at \$1,000 are being amortized over their average useful economic life of 10 years (\$100 annual amortization expense).

^E Goodwill of \$600 is being amortized over its useful economic life of 20 years (\$30 annual amortization expense).

^F The combination results in \$300 of cost savings per annum resulting primary from elimination of redundant overhead costs.